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SUBJECT: ECONOMIC AND DEVELOPMENT REVIEW COMMITTEE
(EDRC): REVIEW OF GREECE, JUNE 9

1. SUMMARY: SECRETARIAT DRAFT SURVEY OF THE GREEK
ECONOMY GIVES HIGH MARKS TO ECONOMIC POLICY FOR SUS-
TAINED HIGH RATE OF DOMESTIC DEMAND, OUTPUT AND EMPLOY-
MENT, BUT EVIDENCES GREAT CONCERN ABOUT PERSISTENTLY
HIGH INFLATION RATE AND INCREASING COST PRESSURES DUE
AT LEAST IN PART TO RECENT WAGE SETTLEMENTS. TAKING
A LONGER VIEW, SECRETARIAT ANALYSIS SUGGESTS THAT INVI-
SIBLE AND CAPITAL INFLOWS HAVE REDUCED PRESSURE ON
GREECE TO DEVELOP INDUSTRIAL EXPORT STRENGTH, HAVE CRE-
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ATED CHRONICALLY "TRADE OVERVALUED" DRACHMA AND HAVE
PERMITTED EXCESSIVE PROPENSITY TO IMPORT. SECRETARIAT
PROPOSES THAT ANTI-INFLATION POLICY MUST BE THE CENTRAL
CONCERN IN THE NEAR FUTURE WITH SUPPLEMENTARY POLICIES
DESIGNED TO STIMULATE MANUFACTURING INVESTMENT AND
DIVERSIFY EXPORTS. MISSION WELCOMES PARTICIPATION OF
EMBASSY ATHENS' ECONOMIC/COMMERCIAL OFFICER BLACK AT
EDRC REVIEW SCHEDULED FOR JUNE 9. END SUMMARY

2. RECENT TRENDS: SECRETARIAT DRAFT SURVEY CENTERS ON

INFLATIONARY TRENDS AS MOST WORRISOME FEATURE OF GREEK ECONOMY. REAL OUTPUT AND EMPLOYMENT ARE STRONG, HELPED BY EXPANSIONARY FISCAL STANCE AND MORE-THAN-ACCOMMODATIVE MONETARY POLICY. REAL 1977 OUTPUT GROWTH (3-3/4 PERCENT) SAGGED SLIGHTLY FROM RECENT TRENDS DUE TO SLOWDOWN IN INCREASE PRIVATE DISPOSABLE INCOME (THUS PRIVATE CONSUMPTION PARTIALLY DUE STRONG FISCAL DRAG) AND NEGATIVE REAL EXTERNAL BALANCE (-1/2 PERCENTAGE POINT CONTRIBUTION TO GROWTH). GOVERNMENT CONSUMPTION AND PRIVATE RESIDENTIAL INVESTMENT INCREASED AT FAST PACE. MANUFACTURING INVESTMENT DECLINE FOR THIRD STRAIGHT YEAR. LABOR MARKET CONDITIONS ARE APPARENTLY TIGHT, BUT STRUCTURAL FEATURES OF LABOR MARKET MAKE IT DIFFICULT TO GET RELIABLE PICTURE. ON EXTERNAL ACCOUNT, TRADE DEFICIT GREW DUE TO WEAK EXPORTS (PROBABLY A DECLINE IN VOLUME) AND STRONG IMPORTS REACTING TO BUOYANT DOMESTIC DEMAND. STRONG RISE IN INVISIBLES SURPLUS ALMOST BALANCED TRADE ACCOUNT DETERIORATION, WHILE AUTONOMOUS CAPITAL INFLOWS, FOREIGN EXCHANGE DEPOSITS AND SUBSTANTIAL OFFICIAL BORROWING (\$185 MILLION) RESULTED IN RESERVE INCREASE OF \$ 137 MILLION. SECRETARIAT BELIEVES THAT DESPITE SLIGHT DROP IN YEAR/YEAR INFLATION RATE FOR 1977 (12 PERCENT VS. 13-1/4 FOR 1976) INFLATIONARY PRESSURES WERE IN FACT LIMITED OFFICIAL USE
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STRONGER SINCE (A) INFLATION DUE TO DRACHMA DEVALUATION WAS LESS; (B) FACTOR COST DEFLATORS WERE 1-1/2 TO 2 POINTS ABOVE CPI; (C) ADMINISTRATIVE PRICES WERE HELD DOWN ARTIFICIALLY; AND (D) HOUSING PRICE SURGE HAS NOT YET WORKED THROUGH TO ITS FULL IMPACT ON CPI. UNIT LABOR COSTS MODERATED SLIGHTLY (16-1/2 PERCENT INCREASE VS. 19 IN 1976), WHILE PROFITS AND OTHER NON-WAGE INCOMES INCREASED AT ABOUT SAME RATE AS NON-AGRICULTURAL EARNINGS (19 PERCENT).

3. MEDIUM-TERM ISSUES: SECRETARIAT ENGAGES IN INDEPTH ANALYSIS OF GREEK INDUSTRIAL SECTOR AND CONCLUDES THAT DESPITE CERTAIN POLICIES TO ENCOURAGE INDUSTRIAL INVESTMENT, PARTICULARLY IN MANUFACTURING, THE OVERALL COURSE

OF EVENTS HAS MITIGATED AGAINST A STRONG DIVERSIFIED INDUSTRIAL SECTOR. IMPORT SUBSTITUTION POLICY IN EARLY POST-WAR PERIOD GAVE RISE TO HIGHLY PROTECTED DOMESTIC INDUSTRIES WHICH ARE GENERALLY NOT INTERNATIONALLY COMPETITIVE, ALTHOUGH PROTECTIVE BARRIERS HAVE BEEN COMING DOWN SINCE 1953 DEVALUATION. EXPORT MIX ALSO SHOWS MODEST INDUSTRIALIZATION AS MOST MANUFACTURED EXPORTS ARE PROCESSED RAW MATERIALS AND LIGHT MANUFACTURES; EXPORTS OF TECHNOLOGICALLY-ADVANCED PRODUCTS PER CAPITA ARE ONE-THIRD TO ONE-HALF LEVEL IN OTHER SOUTHERN EUROPEAN COUNTRIES. GAP BETWEEN OECD AVERAGE AND GREEK

INDUSTRIAL PRODUCTION PER CAPITA IS NARROWING ONLY SLOWLY (FACTOR OF 5-1/2 IN 1960, 3 IN 1977), ATTRIBUTABLE IN LARGE PART TO EXTREMELY LOW PERCENTAGE GNP DEVOTED TO MANUFACTURING INVESTMENT. SECRETARIAT ANALYZES IMPACT OF LARGE CURRENT AND AUTONOMOUS CAPITAL TRANSFERS (AVERAGING 10 PERCENT GDP SINCE 1960 INCLUDING WORKERS' REMITTANCES, SHIPPING REVENUES, REAL ESTATE PURCHASES) AND CONCLUDES THAT THESE INFLOWS HAVE MADE POSSIBLE HIGH PROPENSITY TO IMPORT AND HIGHER-THAN-OTHERWISE STANDARDS OF LIVING, BUT HAVE CONTRIBUTED TO "OVERVALUATION" OF LIMITED OFFICIAL USE
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DRACHMA WITH RESPECT TO COMMODITY TRADE. INFLOWS HAVE ALSO REDUCED PRESSURE TO DEVELOP INDUSTRIAL EXPORT SECTOR AND HAVE SIMULTANEOUSLY MADE IT MORE DIFFICULT GIVEN "TRADE OVERVALUED" DRACHMA. SECRETARIAT ALSO FEELS INFLOWS HAVE CONTRIBUTED TO INFLATIONARY PRESSURES VIA SPECULATION IN REAL ESTATE WHICH MADE REAL ESTATE "SAFEST AND MOST PROFITABLE ASSET TO HOLD" THUS DEFLECTING FUNDS FROM MORE PRODUCTIVE INVESTMENTS. TRANSMISSION OF REAL ESTATE PRICES TO REST OF ECONOMY UNUSUALLY STRONG IN GREECE, ACCORDING TO SECRETARIAT, SINCE REAL ESTATE IS POINT OF REFERENCE FOR REAL VALUE OF MONEY INCOMES, THUS REAL ESTATE INCREASES CREATE PRESSURE FOR CORRESPONDING INCREASE IN WAGES AND SALARIES.

4. SECRETARIAT 1978 FORECAST: BASED ON SUBSTANTIAL INCREASE IN EARNINGS AND OTHER INCOMES, TAX RELIEF TO CUT INTO FISCAL DRAG, BUT SOME RESTORATION OF SAVINGS RATE, SECRETARIAT FORECAST PRIVATE CONSUMPTION RISE OF 5 PERCENT. GOVERNMENT CONSUMPTION SHOULD DECELERATE SLIGHTLY TO 5-1/4 PERCENT INCREASE, WHILE PUBLIC INVESTMENT IS EXPECTED TO INCREASE 4 PERCENT AS AGAINST AN ALMOST 15 PERCENT DROP IN 1977. PRIVATE INVESTMENT IS FORECAST TO INCREASE OVER 9 PERCENT, AS HOUSING SLOWS SLIGHTLY WHILE MANUFACTURING INVESTMENT REMAINS WEAK. FINAL DOMESTIC DEMAND THUS WOULD INCREASE 5-1/2 PERCENT; STOCKBUILDING IS EXPECTED TO BE SLIGHTLY POSITIVE. WEAK WORLD TRADE GROWTH AND PROTECTIONIST TENDENCIES IN MAJOR MARKETS WILL HAMPER EXPANSION OF MANUFACTURED EXPORTS, ALTHOUGH AGRICULTURAL EXPORTS SHOULD IMPROVE. IMPORT VOLUME WILL BE STRONG AGAIN REFLECTING STRONG DOMESTIC, ESPECIALLY CONSUMER, DEMAND. REAL FOREIGN BALANCE IS FORECAST TO CUT ONE POINT FROM GDP GROWTH, LEAVING IT AT 4-3/4 PERCENT. TERMS OF TRADE ARE EXPECTED TO DETERIORATE RESULTING IN A DETERIORATION IN THE CURRENT BALANCE
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ORATE RESULTING IN A DETERIORATION IN THE CURRENT BALANCE

(TO \$1-1/2 BILLION TO 2 BILLION) DESPITE CONTINUED STRONG INVISIBLE EARNINGS. PRICE INCREASES (CPI) ARE EXPECTED TO BE IN THE 13-14 PERCENT RANGE, WITH ACCELERATION IN COST PRESSURES DUE TO RECENT WAGE AGREEMENTS.

5. SECRETARIAT'S CONCLUSIONS:

(A) THE MOST IMPORTANT IMMEDIATE TASK OF POLICY IS TO BRING DOWN APPRECIABLY THE RATE OF INFLATION. DOMESTIC FACTORS, NOTABLY SUBSTANTIAL NOMINAL RISES OF WAGES AND SALARIES FOR THE FOURTH SUCCESSIVE YEAR AND PROBABLY EVEN HIGHER INCREASES IN NON-WAGE INCOMES, HAVE PLAYED A MAJOR ROLE IN SUSTAINING THE HIGH RATE OF INFLATION. IT WOULD SEEM EXTREMELY DESIRABLE TO GET AGREEMENT AMONG THE SOCIAL PARTNERS TO ABOUT HALVE THE RATES OF NOMINAL PAY INCREASES AND PRICE RISES DURING THE PERIOD OF THE NEXT COLLECTIVE AGREEMENTS. THE ROLE OF DEMAND MANAGEMENT IN THE FIGHT AGAINST INFLATION REMAINS, HOWEVER, INDISPENSABLE. THE GOVERNMENT SECTOR SHOULD CONTRIBUTE DIRECTLY TO REDUCING ITS CLAIMS ON RESOURCES FOR CURRENT CONSUMPTION. CONTINUING SUBSTANTIAL BUDGET DEFICITS (ABOUT 6-3/4 PERCENT OF GDP) FOR THE THIRD YEAR RUNNING, WHEN UNEMPLOYMENT IS AT HISTORICALLY LOW LEVELS AND WHEN THE DEFICITS ARE ESSENTIALLY ATTRIBUTABLE TO CURRENT EXPENDITURE, SEEM TO BE INCONSISTENT WITH THE AIM OF REDUCING INFLATION AND THE LONGER-RUN NEED TO PROMOTE DEVELOPMENT BASED ON THE GROWTH OF PRODUCTIVE CAPACITY. CURRENT TRENDS SUGGEST THAT THE MONETARY AND CREDIT TARGETS SET FOR 1978 ARE LIKELY TO BE EXCEEDED AGAIN BY A CONSIDERABLE MARGIN IN THE ABSENCE OF SOME TIGHTENING OF POLICY. NOT ONLY SHOULD THE INCREASE OF TOTAL BANK CREDIT TO THE PRIVATE SECTOR BE KEPT WITHIN REASONABLE LIMITS BUT ALSO THE BANK OF GREECE MAY HAVE TO SEE THAT THE FUNDS ARE USED FOR PRODUCTIVE ENDS AND NOT TO FINANCE EXCESSIVE RISES IN CONSUMPTION AND IN HOUSEBUILD-LIMITED OFFICIAL USE
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ING, WHICH ARE NOT CONSISTENT WITH THE OBJECTIVES TO REDUCE INFLATION AND IMPROVE THE BALANCE OF PAYMENTS SITUATION.

(B) GREECE SUFFERS FROM IMPORTANT STRUCTURAL DEFICIENCIES IN MANUFACTURING; NOTABLY A SMALL MANUFACTURING SECTOR COMBINED WITH A COMPOSITION OF OUTPUT WHICH DOES NOT CORRESPOND TO THE LEVEL OF THE COUNTRY'S ECONOMIC DEVELOPMENT OR TO THE CHANGING PATTERN OF DOMESTIC DEMAND AND OF INTERNATIONAL TRADE FLOWS. THE SUBSTANTIAL INCREASE IN THE TRADE DEFICIT IN THE LUST FEW YEARS IS ALSO A REFLECTION OF THIS SITUATION. THE SIZEABLE FALL IN MANUFACTURING INVESTMENT SINCE 1974 IS, THEREFORE, A SERIOUS SETBACK WHICH MAY ADVERSELY AFFECT

MEDIUM-TERM GROWTH PROSPECTS, REINFORCE THE BALANCE OF PAYMENTS CONSTRAINT AND HEIGHTEN INFLATIONARY PRESSURES. THE INTRODUCTION OF NEW INVESTMENT AND EXPORT INCENTIVE MEASURES WILL CLEAR SOME OF THE UNCERTAINTIES AND MAY HELP SOME REVIVAL OF MANUFACTURING INVESTMENT. THE NEW FIVE YEAR PLAN, DUE TO BE PRESENTED THIS YEAR, MAY ALSO CONTAIN CERTAIN INDICATIONS AS TO THE LONG-TERM POLICIES TO BE FOLLOWED IN THIS AREA. HOWEVER, EFFECTIVE MEASURES TO REDUCE THE DISTORTIONS WHICH IMPEDE A LARGER SHARE OF RESOURCES GOING TO PRODUCTIVE USES, NOTABLY BY LESSENING THE EXCESSIVE DEPENDENCE FOR GROWTH ON HOUSING CONSTRUCTION AND ALSO BY MOVING PART OF THE EXCESS PROFITS OF THE TERTIARY SECTOR TO INDUSTRY, WOULD CONSIDERABLY CONTRIBUTE IN ACHIEVING A SELF-SUSTAINED HIGH RATE OF INDUSTRIAL GROWTH.

(C) RECEIPTS FROM SHIPPING AND EMIGRANTS' REMITTANCES, AS WELL AS OF VARIOUS TRANSFERS OF FUNDS FROM GREEKS WORKING ABROAD WILL INEVITABLY PLAY A LESS IMPORTANT LIMITED OFFICIAL USE
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ROLE IN COMING YEARS. DUE TO THE REVERSAL OF MIGRATION FLOWS, ONLY MODERATE INCREASES IN THE VALUE OF REMITTANCES CAN BE EXPECTED IN THE FUTURE. WITH REGARD TO RECEIPTS FROM SHIPPING, THEIR RATHER REMARKABLE PROGRESS UNTIL LAST YEAR CAN LARGELY BE ATTRIBUTED TO THE SPECIAL FEATURES OF THE GREEK-OWNED FLEET. BUT THE EXPECTED PROLONGED CRISIS IN WORLD SHIPPING CANNOT FAIL TO AFFECT THIS IMPORTANT SOURCE OF FOREIGN EXCHANGE. ACCORDINGLY, GROWTH OF THE GREEK ECONOMY WITH A CURRENT EXTERNAL DEFICIT OF AN ACCEPTABLE SIZE IS LIKELY TO DEPEND INCREASINGLY IN THE FUTURE ON THE EXPANSION AND DIVERSIFICATION OF INDUSTRIAL PRODUCTION AND EXPORTS. MOREOVER, AN IMPORTANT PART OF EXISTING INDUSTRY -- MAINLY LIGHT CONSUMER MANUFACTURES -- WILL FACE INCREASING COMPETITION FROM OUTSIDE THE OECD AREA IN THE FUTURE. THE DEGREE OF NECESSARY RESTRUCTURING OF OUTPUT WILL PROBABLY BE VERY IMPORTANT AND CAN ONLY TAKE PLACE IF A HIGHER SHARE OF AVAILABLE RESOURCES IS DEVOTED TO PRODUCTIVE INVESTMENT AND IF SUFFICIENT CONTROL OF DEMAND AND COST PRESSURES CREATES A STABLE ECONOMIC ENVIRONMENT AND PROVIDES SUFFICIENT INCENTIVES FOR PRODUCTIVE RATHER THAN SOCIALLY WASTEFUL USE OF NATIONAL RESOURCES.

6. COMMENTS:

(A) SECRETARIAT HIGHLIGHTS 1978 BUDGET PROPOSALS TO

REDUCE FISCAL DRAG
IN THE ECONOMY, BUT DOES NOT COMMENT
ON REGRESSIVE TAX SYSTEM CITED BY EMBASSY ATHENS (ATHENS

2114). HIGH FISCAL DRAG MAY BE CONSISTENT WITH HIGHLY REGRESSIVE TAX SYSTEM IN GREEK SITUATION WHERE RECENT EMPHASIS HAS BEEN ON WAGE INCREASES FOR LOWER INCOME GROUPS. HOWEVER, ONE NORMALLY ASSOCIATES FISCAL DRAG WITH PROGRESSIVE DIRECT TAX SYSTEMS. MISSION PLANS EXPLORE THIS QUESTION WITH GREEK DELEGATION AND SECRE-
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TARIAT, ESPECIALLY IN RELATION TO USEFULNESS OF PROPOSED CHANGES IN DIRECT TAX STRUCTURE TO ESSENTIALLY ALTER INHERENT DRAG IN SYSTEM.

(C) SECRETARIAT MAKES A FAIRLY STRONG CASE THAT INVISIBLE AND CAPITAL INFLOWS HAVE PERMITTED MAINTENANCE OF OVERVALUED EXCHANGE RATE. IT WOULD APPEAR, HOWEVER, (E.G., FROM 77 ATHENS 6148) THAT GOVERNMENT POLICY IS DIRECTED TO MAINTENANCE OF EXISTING EXCHANGE RATE (OR SOMETHING CLOSE TO IT) TO PREVENT INFLATIONARY EFFECTS OF DEVALUATION. POLICY DILEMMA THUS CREATED BETWEEN ANTI-INFLATION AND INDUSTRIALIZATION GOALS. MISSION WOULD APPRECIATE EMBASSY ATHENS' COMMENT ON SECRETARIAT'S ANALYSIS OF EXCHANGE RATE LEVEL AND, BASED ON THAT, WOULD EXPLORE INFLATION/INDUSTRIAL DEVELOPMENT ASPECTS OF FOREIGN EXCHANGE INFLOWS.

(C) MISSION PLANS TO SUPPORT SECRETARIAT POSITION THAT INFLATION IS CURRENTLY THE MOST SERIOUS PROBLEM IN GREECE AND THAT STANCE OF FISCAL AND MONETARY POLICY SEEMS INCONSISTENT WITH ATTEMPT TO MODERATE INFLATION. IN THIS REGARD, MISSION WOULD APPRECIATE INFORMATION ON HISTORY OF CONSENSUS TYPE WAGE PRICE AGREEMENTS IN GREECE.
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